

# *Oversight Report*



NAVAL AUDIT SERVICE PROCESS FOR DETERMINING AUDIT  
REQUIREMENTS AND REQUESTING RESOURCES

Report Number D-2000-6-005

April 17, 2000

Office of the Inspector General  
Department of Defense

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### **Acronyms**

APG	Audit Planning Group
ASN (FM&C)	Assistant Secretary of the Navy (Financial Management and Comptroller)
CFO	Chief Financial Officers Act
DON	Department of the Navy
FTE	Full-time Equivalents
NAS	Naval Audit Service
OIG	Office of the Inspector General



INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE  
400 ARMY NAVY DRIVE  
ARLINGTON, VIRGINIA 22202

April 17, 2000

MEMORANDUM FOR NAVAL INSPECTOR GENERAL

SUBJECT: Evaluation Report on Naval Audit Service Process for Determining Audit Requirements and Requesting Resources (Report No. D-2000-6-005)

We are providing this report for information and use. We considered management comments on a draft of this report when preparing the final report.

The Navy comments conformed to the requirements of DoD Directive 7650.3 and left no unresolved issues. Therefore, no additional comments are required.

We appreciate the courtesies extended to the evaluation staff. For additional information on this report, please contact Ms. Patricia A. Brannin at (703) 604-8802 (DSN 664-8802) (pbrannin@dodig.osd.mil) or Mr. M. Thomas Heacock at (703) 604-8756 (DSN 664-8756) (mheacock@dodig.osd.mil). See Appendix D for the report distribution. Evaluation team members are listed on the back cover.

A handwritten signature in black ink, reading "Robert J. Lieberman", is positioned above the typed name.

Robert J. Lieberman  
Assistant Inspector General  
for Auditing

## Office of the Inspector General, DoD

Report No. D-2000-6-005

(Project No 9OA-9009)

April 17, 2000

### Naval Audit Service Process for Determining Audit Requirements and Requesting Resources

#### Executive Summary

**Introduction.** The Under Secretary of the Navy is responsible for the Department of Navy internal audit function. The Auditor General is the senior Department of the Navy advisor to the Under Secretary of the Navy on all audit-related matters. The Naval Audit Service (NAS), under the direction of the Auditor General, is responsible for conducting internal audits for the Department of the Navy. As Director of the NAS, the Auditor General maintains operational control over internal audits, audits of commercial activities, and other mission functions conducted by the NAS.

On September 25, 1997, the Under Secretary of the Navy directed the creation of an Audit Planning Group consisting of the Auditor General and senior Navy management representatives. The Audit Planning Group reviews and comments on the NAS audit plan.

**Objectives.** The overall objective of the evaluation was to assess the process for determining audit requirements and for requesting audit resources. We also determined whether the planning process was responsive to management needs and whether policy or resource constraints impaired auditor independence. We have performed similar reviews recently at the Army Audit Agency and the Air Force Audit Agency.

**Results.** The NAS processes for determining audit requirements and resource needs were effective. Nothing came to our attention to indicate that the NAS had any actual impairment to independence. However, two sets of issues warranted management's attention.

- The Audit Planning Group concept had merit as a vehicle for ensuring that the NAS audit plan was responsive to management needs and there were no indications that the Group's activities had resulted in audits being avoided; however, some refinements were needed to the Group's charter. The charter should be clear that the Under Secretary of the Navy is the final review authority for the audit plan, and the Auditor General should have explicit recourse to adjudication by the Under Secretary of the Navy if disagreements occur within the Group regarding planned audit coverage (finding A).
- The NAS process for determining resources requirements was effective. However, a new process implemented by the Navy making financial statement audits a reimbursable service was administratively cumbersome,

had no demonstrable advantage over direct funding in the NAS budget, and created potential instability in the overall planning of annual DoD financial statement audits (finding B).

**Summary of Recommendations.** We recommend that the Under Secretary of the Navy amend the Audit Planning Group charter to establish the Under Secretary as the final review authority for the audit plan. We recommend that the Under Secretary of the Navy be designated as the adjudication authority for disagreements between the Auditor General and Audit Planning Group members regarding planned audit coverage. We recommend that the Under Secretary of the Navy terminate the reimbursement arrangement and return the Naval Audit Service Chief Financial Officers Act audit work to mission funding in the Naval Audit Service budget by FY 2001.

**Management Comments.** The Navy concurred with the recommendation to designate the Under Secretary of the Navy as the final review authority for the audit plan. The Navy concurred with the intent of the recommendation to designate the Under Secretary of the Navy as the adjudication authority for unresolved issues between the Auditor General of the Navy and Audit Planning Group. However, the Navy stated that this would be accomplished during the review of the audit plan by the Under Secretary of the Navy, therefore, the charter does not need to be revised. The Navy concurred with the intent of the recommendation to terminate the reimbursement arrangement by FY 2001. However, the Navy does not anticipate that mission funding of all financial statement audit work by the Naval Audit Service would be accomplished until October 1, 2001. A discussion of management comments is in the Finding section of the report and the complete text is in the Management Comments section.

**Evaluation Response.** The management comments were responsive. The actions taken by the Navy management meet the intent of the recommendations.

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## Background

**Naval Audit Service.** According to Secretary of the Navy Instruction 5430.100, "Assignment of Responsibilities to the Department of the Navy Auditor General," August 5, 1987, the Under Secretary of the Navy is responsible for the Department of Navy (DON) internal audit through the Office of the Auditor General. The Auditor General is the senior DON advisor to the Under Secretary of the Navy on all audit-related matters. The Naval Audit Service (NAS) under the direction of the Auditor General is responsible for conducting internal audits in the DON. As Director of the NAS, the Auditor General maintains operational control over internal audits, audits of commercial activities, and other mission functions conducted by the NAS.

**Mission.** The NAS is entrusted by the Secretary of the Navy to provide independent, professional internal audit services that assist naval leadership in improving efficiency, accountability, and program effectiveness. To accomplish that mission, the NAS performs internal audits of DON organizations, programs, activities, systems, functions, and funds. Those audits are to evaluate whether:

- DON information is reliable;
- resources have been safeguarded;
- funds have been expended consistent with laws, regulations, and policies;
- resources have been managed economically and efficiently; and
- desired program performance has been achieved.

**Types of Work.** Within the NAS audit plan, the following types of work are incorporated

- Mandatory audit workload, which is determined by various statutory, regulatory, or policy requirements of higher authorities.
- Requested audit workload, which represents work formally requested by Navy managers.
- Self-initiated audit workload, which is originated by the NAS, although it is often based on input from Navy managers.
- Capacity evaluations and management consulting studies which are initiated in response to requests from Navy and Marine Corps management and provide information needed to help make decisions relating to specific subjects, programs, or problem areas.

**Other Functions.** In addition to performing audits, the NAS performs other functions.



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- Providing audit policy guidance, oversight, and peer reviews of audits conducted by auditors assigned to local commands and DON organizations that are organizationally independent of the NAS.
  - Monitoring DON non-Federal audit services contracts to ensure compliance with DoD policy guidance.
  - Supporting the Naval Inspector General in executing the DON audit followup program.
  - Providing audit assistance to the Naval Criminal Investigative Service

## Objectives

The overall objective of the evaluation was to assess the process for determining audit requirements and for requesting audit resources. We also determined whether the planning process responded to management needs and whether policy or resource constraints impaired auditor independence. We have performed similar reviews recently at the Army Audit Agency and the Air Force Audit Agency.

Our evaluation did not look into the July 1999 rotational reassignment of the Navy Auditor General or the current reorganization of the NAS. Senior NAS managers have kept the Office of the Inspector General (OIG), DoD, informed on both matters. We also did not review the DON A-76 "Performance of Commercial Activities" study at the NAS that was started in April 1999.\* See Appendix A for a discussion of the evaluation scope and methodology, Appendix B for prior coverage, and Appendix C for a discussion of other matters of interest.

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\*The Under Secretary of the Navy terminated the ongoing NAS A-76 study in November 1999

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## A. Determining Audit Requirements

The Audit Planning Group (APG) concept had merit as a vehicle for focusing audit coverage on areas that were of most concern and ensuring that the NAS audit plan was responsive to management needs. In addition, certain important safeguards of NAS independence were in place. However, some refinements were needed to the APG charter. The charter stated that the Secretary of the Navy approved the audit plan, but in practice and under responsibility set forth in Secretary of the Navy Instruction 7510.7E, the Under Secretary of the Navy is the senior review official. Further, the charter did not provide for a resolution mechanism in case of disagreements between the Auditor General and APG members regarding planned audit coverage.

### Audit Requirements

**Identifying Audit Requirements.** The NAS audit liaison officers were primarily responsible for identifying audit requirements. The audit liaison officer concept entailed having an NAS expert in a specific issue area who was responsible for interfacing with Navy management on a continuous basis to identify potential audit topics. Based on the identified requirements, the audit liaison officers submitted audit proposals to the responsible NAS senior executives for review and approval. The NAS senior executives provided guidance to the audit liaisons to ensure that the planned audit coverage addressed each issue area's vulnerabilities.

In addition, NAS auditors were active representatives in the DoD-wide joint planning groups, which were established in FY 1993 by the DoD Audit Chiefs Council to identify subjects most in need of audit, to plan joint audits, and to avoid duplication. Currently, there are 10 DoD-wide joint planning groups covering major DoD functional areas (for example, acquisition, finance and accounting, and environment).

**Formulation of the Audit Plan.** The NAS issued a 2-year audit plan that was updated and published every year. The first year of the plan provided a detailed view of planned or ongoing workload, and the second year of the plan provided more limited information for workload tentatively planned for the second year. The Planning Division at Headquarters NAS provided guidance for formulating the audit plan. After receiving input from the senior executives, the Planning Division was responsible for actually preparing and publishing the 2-year audit plan.

**Review of Audit Plan.** Secretary of the Navy Instruction 7510.7E, "Department of the Navy Internal Audit," October 11, 1991, directs that, after the audit plan is developed, the Auditor General will review the plan with the Under Secretary of the Navy before it is finalized.

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## Use of Audit Planning Group

**Purpose of the APG.** A January 9, 1998, memorandum from the Secretary of the Navy stated that the creation of the APG was an opportunity to bring positive visibility, input, and support from senior Navy leadership to the internal audit function. Further, the memorandum noted that the intent of the group was to help the Auditor General develop an audit plan that was aligned with the overall DON corporate goals and strategies.

**Formation of APG.** In a September 25, 1997, memorandum, the Under Secretary of the Navy directed the creation of the APG, effective November 1, 1997, consisting of the Auditor General and senior representatives of the:

- Under Secretary of the Navy;
- Office of General Counsel;
- Assistant Secretary of the Navy (Financial Management and Comptroller);
- Assistant Secretary of the Navy (Installations and Environment);
- Assistant Secretary of the Navy (Research, Development, and Acquisition);
- Assistant Secretary of the Navy (Manpower and Reserve Affairs);
- Chief of Naval Operations; and
- Commandant of the Marine Corps.

The APG meets, on average, two times a year under the chairmanship of the Auditor General to recommend audit priorities and plans to the Secretary of the Navy. The meetings were initiated by the Auditor General. In a process paralleling that of the Planning, Programming, and Budgeting Process, the Auditor General was required to present a 2-year audit plan to the APG for review and comment no later than 6 months before the beginning of the fiscal year. In addition, the NAS presents to the APG the outcome of audits completed during the previous year, the vulnerabilities on which they focused, and work-in-progress carried forward from the previous years.

**Audit Plan Changes.** Regarding the FY 1999 NAS proposed audit plan, an example of recommendations made by the APG to the Auditor General was increasing the amount of resources dedicated to the intelligence and special audits issue area. In addition, the APG recommended that an audit within the personnel and quality of life issue area be added in place of another quality of life audit. Of the 110 audits included in the FY 1999 draft audit plan as of October 26, 1998, all but two were included in the FY 1999 final audit plan signed by the Auditor General. Because of the few changes made to the NAS

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audit plan, we believe that the NAS process for determining audit requirements was working and the APG was not interfering with the planning process. On the contrary, the APG input was constructive.

According to NAS personnel, if changes were to be made to the approved audit plan during the fiscal year, the NAS Assistant Auditors General would be responsible for coordinating the changes with their respective representatives of the APG. A formal APG meeting would not be held unless the change was significant.

**NAS Independence.** The APG charter established procedures to maintain auditor independence. The charter states that because the APG will consist of senior Navy officials whose organizations may be audited by the NAS, one of the primary guiding principles of APG deliberations will be to maintain auditor independence according to Government Auditing Standards. Accordingly, the deliberations of the APG are not intended to improperly limit or modify the subject, scope, or objectives of an audit, or to impair the independence of or impede the accomplishment of the internal audit function.

The deliberations of the APG were to be recorded in the form of written minutes, with the Auditor General being responsible for preparing the minutes. The APG members present at the meeting have the opportunity to review and comment on the draft minutes before they are finalized. Any changes to audit plans as a result of APG deliberations are to be clearly noted in the official record. The Auditor General is to affirm that recommended APG changes to either planned or ongoing audits do not violate Government Auditing Standards. Based on a review of the written minutes, we believe they provided a reasonable control to maintain auditor independence.

## **Responsiveness of Planning Process to Management Needs**

The NAS previously interviewed various users of its reports to obtain customer feedback, but had discontinued the use of interviews. The NAS was reevaluating reinstatement of this feedback program. Although a formal customer satisfaction program was not in place at the time of our review, we believe that the APG potentially provided an even more effective mechanism to determine whether the planning process was responsive to management needs. To meet its full potential, the APG concept will need the full support and sustained active involvement of senior Navy managers.

## **APG Charter Refinement**

Although the APG concept had merit as a vehicle for focusing audit coverage on areas that were of most concern and ensuring that the NAS audit plan was responsive to management needs, some refinements were needed to the APG charter.

**Audit Plan Approval.** According to the charter, after the audit plan was presented to the APG, the Auditor General would take into account any comments and guidance from the APG, revise the plan accordingly, and submit the plan for Secretary of the Navy approval. But in practice, there had been no

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Secretary of the Navy approval of the audit plan. After the last APG meeting, the plan was reviewed by the Auditor General and the Under Secretary of the Navy. The plan was then issued by the Auditor General. This procedure is in accordance with Navy Instruction 7510.7E. The charter should be revised to align it with the Navy Instruction.

**Disagreements to Planned Audit Coverage.** The charter did not provide for resolution of disagreements between the Auditor General and APG members regarding planned audit coverage. This point was especially significant because it would be inappropriate for Navy managers below the level of the Under Secretary of the Navy to block audit coverage of matters under their cognizance. According to NAS personnel, NAS Assistant Auditors General and respective members of Navy management were responsible for resolving differences regarding planned audit coverage. That process was done outside of official APG meetings. In addition, according to NAS personnel, no major disagreements regarding planned audit coverage have occurred since the APG was created in 1997. However, if a disagreement did occur, the APG charter lacked a resolution mechanism.

## **Conclusion**

The APG was established to assist the NAS in ensuring that audits performed by the NAS meet the needs of the DON. Because of the formation of the APG, there has been more active dialogue between APG members and senior managers of the NAS. This interaction has been constructive. The APG charter's provisions that the Auditor General chairs the APG and APG meeting minutes are prepared by the NAS are good controls, but we suggest others for Navy consideration to avoid potential confusion and perceptions of impaired independence.

## **Recommendation and Management Comments**

**A. We recommend that the Under Secretary of the Navy amend the Audit Planning Group charter to:**

- 1. Designate the Under Secretary of the Navy as the final review authority for the audit plan.**
- 2. Designate the Under Secretary of the Navy as the adjudication authority for unresolved disagreements between the Auditor General and Audit Planning Group members regarding planned audit coverage.**

**Management Comments.** The Navy concurred with the recommendation to designate the Under Secretary of the Navy as the final review authority for the audit plan. The Navy stated that the Audit Planning Group Charter would be revised by May 31, 2000. The Navy agreed with the intent of the recommendation to designate the Under Secretary of the Navy as the adjudication authority for unresolved issues between the Auditor General and the Audit Planning Group regarding planned audit coverage. However, the

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Navy stated that would be accomplished during the review of the audit plan by  
• the Under Secretary of the Navy; therefore, it was not necessary to revise the  
charter

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## B. Resource Issues

The NAS processes for determining requirements for and requesting resources were effective. However, the Navy policy that made NAS Chief Financial Officers (CFO) Act financial statement audits a reimbursable service was inefficient and created concerns about the stability of future Navy funding of the statutorily required CFO audits. The reimbursable process was established to change how Navy organizations view NAS audit products, but the Audit Planning Group is a much better way to link the audit plan to Navy management priorities and discourage marginally useful audit requests. In addition, the scope of core audit effort in support of the overall DoD CFO Act audit program is determined by the Inspector General, DoD, and the NAS, not individual Navy fund holders. The new reimbursement process also created an unnecessary budgeting and accounting burden on the NAS and had no demonstrable benefits.

### Resource Planning

The NAS process for determining requirements for and requesting resources were effective. For further details see Appendix C.

### Reimbursement Arrangement

**Background.** In June 1997, the Under Secretary of the Navy, in an attempt to change how audit services were provided within the DON, issued a memorandum instructing the Assistant Secretary of the Navy, Financial Management and Comptroller (ASN (FM&C)), to convene a working group to determine how and what types of audits could be provided on a reimbursable basis in FY 1999 and beyond. The idea of providing audits on a reimbursable basis was an attempt to make the Navy operate more like a private sector company that pays auditing or accounting firms for required audits.

**July 1997 Memorandum.** In July 1997, the Under Secretary of the Navy issued a followup memorandum to clarify his June 1997 message. In the July 1997 memorandum, the Under Secretary of the Navy stated that his June message was not about "how to maintain the Naval Audit Service status quo and just redistribute costs, but was intended to look at fundamental change in how the Navy provided the audit product." The memorandum further stated:

I am making this clarification because my use of the term "reimbursable basis" may have been misinterpreted. My intent was not to call for a classic reimbursable accounting process with the Naval Audit Service performing the work and being reimbursed. Rather it is intended to denote individual activities paying for audit product they need and desire instead of it being provided as a "free" good.

The memorandum again reiterated that the ASN (FM&C) working group review should determine which type of audits should continue to be financed by the NAS and which could be paid for in another manner.

**ASN (FM&C) Working Group.** The ASN (FM&C) convened a working group composed of various Navy members including the NAS, the Marine Corps, and Navy budgeting and accounting personnel. The group examined various funding alternatives. As a result of its effort, in August of 1997, the working group developed nine alternatives under three main NAS funding categories: (1) Mission Funded, (2) Fully Reimbursable, and (3) Partial Reimbursable/Mission Funded.

**Partial Reimbursable/Mission Funded.** In a September 1997 memorandum, the Under Secretary of the Navy directed that for FY 1999, CFO financial statement audits performed by the NAS would be funded in the budgets of the benefiting commands. Thus, the costs of auditing the Navy Working Capital Fund and the Navy General Fund would be included as a cost of operations in the budgets of the appropriate DON management command associated with the two funds. All other NAS audit work would remain mission funded. For FY 2000 and beyond, the memorandum stated that the benefiting commands would be expected to fund audit products from their own budgets, whether or not those products are provided by the NAS.

**CFO Audit Funding.** In October 1997 in accordance with the Under Secretary of the Navy September 1997 memorandum, funding from the Assistant for Administration, the Under Secretary of the Navy (the NAS funding claimant) FY 1999 budget was redistributed among the 10 Navy Working Capital Fund and Navy General Fund organizations (for example, the Naval Air Systems Command, Naval Sea Systems Command, and the Marine Corps). Budget mark 62477 redistributed \$8.954 million to the Working Capital Fund organizations, and budget mark 62478 redistributed \$7.196 million to the General Fund organizations for a total of \$16.150 million. The original \$16.150 million was based on an NAS estimate of 202 Full-time Equivalents (FTE) to perform the financial statement audits in FY 1999. The 202 FTE number was multiplied by an average work year cost of \$79,950. The two budget marks also displayed similar distributions for FYs 2000 to 2003 increasing the distribution amount 2 percent per year

During FY 1999, the NAS was to review its actual costs to determine whether adjustments to the original distribution of funding were required for the 10 Navy organizations. The NAS and the office of the ASN (FM&C) worked closely together to make such fund redistributions throughout the fiscal year. The NAS 202 FTE to perform FY 1999 financial audit work was reduced to about 150 FTE for FY 2000. The reduction related to the NAS reorganization and cost reduction efforts that started in late FY 1999 but did not affect the core audit work that NAS needed to perform, as defined by coordination with the Inspector General, DoD.



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## Reimbursement Implementation

**Agreement.** In April 1998, a memorandum of agreement was drafted for signature by the Auditor General; the Assistant for Administration, Office of the Under Secretary of the Navy; and the Directors of the ASN (FM&C) Office of Financial Operations and the Office of Business and Civilian Resources Division. The purpose of the memorandum was to detail how the reimbursement arrangement would be implemented. The memorandum stated that the reimbursement would be a fixed price effort, which meant that the entire predetermined amount of \$16.150 million would be billed by the NAS. Reimbursement requests exceeding the \$16.150 million would not be honored, and likewise, if there were any money remaining in the reimbursement funding, it would be completely billed or exhausted.

The memorandum of agreement, although signed by the Auditor General and the Assistant for Administration, was not approved by the Director of the Office of Business and Civilian Resources Division, ASN (FM&C). The Director did not agree with the memorandum because the Economy Act, title 31, United States Code, section 1535, requires agencies, under a reimbursable program, to recover the actual cost of goods and services provided. The Economy Act authorized one agency to place orders for goods and services with another agency. However, the ordering agency was required to reimburse the performing agency for the actual cost of the goods or services provided. Thus, the reimbursement arrangement could not be based on a predetermined fixed amount as previously planned. The NAS would have to develop a system to capture actual costs to bill the 10 Navy organizations.

**Reimbursement Mechanics.** The task of keeping track of FY 1999 CFO cost attributable to the 10 Navy organizations has been a daunting one for the NAS. The NAS estimated 202 FTE to perform the FY 1999 CFO work. The 202 FTE included 188 NAS auditors and the balance from contractor support. To implement the process, the NAS identified and officially reassigned 188 NAS personnel as CFO auditors. This official personnel reassignment was made so that the NAS could try and keep track of payroll, travel, and training cost for each designated NAS CFO auditor at the 10 Navy organizations. The NAS also developed a job ordering coding system with approximately 100 job ordering codes that were used to bill the Navy customers. For example, code 1A represented the Naval Air Systems Command. Salaries for the Naval Air Systems Command CFO related audit work were represented by code A1111. The Naval Air Systems Command related travel was represented by order code A2104 and that was included in the auditor's travel order accounting citation. For each of the billable costs, there was an identifying code to accumulate costs

Based on expenditures charged to its applicable reimbursable job orders, the NAS would bill the CFO activity through the Navy Standard Accounting and Reporting System. The Navy organizations provided the requisite funding to the NAS using Navy Comptroller Form 2275 (Order for Work and Services). The approved 2275 amount was entered into the Standard Accounting and Reporting System and was then available for obligation by the NAS.

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## Reimbursement Benefits

**Benefits.** There are no discernable benefits from continuing the current reimbursable arrangement. The current reimbursement is simply an unnecessary and cumbersome budgetary and accounting transaction process between multiple Navy organizations and the NAS with no particular benefits to the 10 Navy organizations or the NAS. As predicted by the ASN (FM&C) working group, the reimbursement process has been burdensome for the NAS in its attempt to manage the costs of individual auditor's time, travel, and training, as they relate to the 10 Navy organizations. Likewise, those 10 organizations are encumbered with additional administrative requirements. Given the chronic problems experienced by the Navy in the finance and accounting area, it should avoid unnecessarily complex funding and accounting arrangements.

We recognize the intent of the Under Secretary of the Navy 1997 memoranda to rethink how the Navy views its audit product. The Under Secretary of the Navy did not want the NAS to be perceived as a free service to the DON because there is a cost associated with audits. The implication was that some Navy activities were requesting marginally useful audits and audit priorities were questionable.

We believe that the reimbursement process did not produce the desired result. The current situation is indeed what the Under Secretary of the Navy wanted to prevent when he stated that the reimbursement arrangement was not "about how to maintain the NAS status quo and just redistribute costs." However, that is exactly what has taken place. The costs of performing certain financial audits have merely been redistributed to 10 Navy organizations. Thus, we believe that the reimbursable process has not had any demonstrable impact on audit priorities.

**CFO Act Audit Responsibility and Reimbursement Arrangement.** The Chief Financial Officers Act of 1990 requires that financial statements for the DoD be audited by the Inspector General, DoD, or by an independent external auditor, as determined by the Inspector General. In March 1991, because the Inspector General, DoD, determined that the Military Department audit organizations were in the best position to audit their respective funds, the Navy financial statement audit work was delegated to the NAS. Thus the primary focus of NAS financial statement audits is to support the Inspector General, DoD, in its responsibility to render opinions on the DoD financial statements.

The scope of this core DoD CFO Act auditing is determined by, and is the responsibility of, the Inspector General, DoD, and the NAS, not the managers of Navy fund holding activities. The DoD audit effort related to the CFO Act is the most massive and longest sustained financial audit effort in the history of any Federal agency. Its scope and complexity are significant audit management challenges and the IG, DoD, strongly opposes individual DoD component initiatives that create further risks. In this case, depending on multiple sources of funding introduces instability into audit resource planning. Eventually, when unqualified audit opinions on Navy financial statements are likely, the Inspector General, DoD, plans to revisit the entire spectrum of issues related to

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financial statement auditing, in consultation with appropriate Navy officials. At the current time, the Navy reimbursable arrangement for NAS financial statement auditing is premature, as well as not beneficial.

**Continuance of Arrangement.** In a memorandum dated September 20, 1999, the ASN (FM&C) continued the reimbursable arrangement into FY 2000. The memorandum also required an evaluation at the end of FY 2000 of whether the program should continue. The memorandum pointed out the difficulties the NAS has had in implementing the arrangement and instructs the NAS to correct the deficiencies.

## **Conclusion**

The continuance of the reimbursable arrangement for NAS audits serves no beneficial purpose for the DON whose concerns over audit priorities can be more effectively addressed through the Navy Audit Planning Group, as discussed previously in this report. In addition, the Inspector General, DoD, objects to the risk of resource planning instability that the reimbursable process injects into the overall DoD CFO Act auditing effort.

## **Management Comments on Finding and Evaluation Response**

**Navy Comments on the Finding.** The Navy stated that several editorial changes should be made to the finding. According to the Navy, there has never been a question that funding would not be provided for financial audits. The Navy was committed to ensuring that financial audits were fully funded. The Navy stated that the reference in the finding paragraph regarding the OIG, DoD, concerns about the stability of future Navy funding of the statutorily required CFO audits be deleted. In addition, the Navy stated that if properly implemented that reimbursable funding was not a complex issue. Therefore, the Navy suggested that the last sentence of the first paragraph of page 11 stating that the Navy should avoid unnecessarily complex funding and accounting arrangements be deleted. Finally, the Navy suggested that the third paragraph of page 11 dealing with the reimbursement process be rewritten because the conclusion appears to be based on opinion.

**Evaluation Response.** We have not deleted the reference to the OIG, DoD, concerns about the stability of future Navy funding of statutorily required CFO audits. The scope and complexity of the DoD audit effort are significant audit management challenges and depending on multiple sources of funding introduces instability into audit resource planning. We also disagree with the Navy that, if properly implemented, reimbursable funding is not a complex arrangement. The paragraph containing our conclusions regarding the efficacy of the reimbursable process has been reworded, but we are confident that the facts fully support our opinion.

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## **Recommendation and Management Comments**

**B.** We recommend that the Under Secretary of the Navy terminate the current reimbursement arrangement for financial statement audits and return the Naval Audit Service financial statement audit work to mission funding by FY 2001.

**Management Comments.** The Navy concurred with the intent of the recommendation to terminate the current reimbursement arrangement for financial statement audits by FY 2001. However, the Navy stated that mission funding of all financial statement audit work performed by the Naval Audit Service cannot be accomplished by October 1, 2000. While realignment of Operations and Maintenance, Navy funds will be changed, other appropriations cannot be realigned without prior Congressional approval. It is not anticipated that mission funding of all financial statement audit work performed by the Naval Audit Service would be accomplished until October 1, 2001.

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## Appendix A. Evaluation Process

### Scope and Methodology

We reviewed DoD, Navy, and NAS policies and procedures in force from 1987 through 1999 that related to the process for determining audit requirements and requesting audit resources. We also discussed with Navy and NAS personnel what changes were made to the planning process since FY 1998. In addition, we reviewed the NAS 2-year audit plan and the NAS process for determining audit requirements. In addition, we reviewed the APG role in the process for determining audit requirements. Also, we reviewed the APG charter. Regarding the process for requesting audit resources, we reviewed the reimbursable arrangement that the NAS has for CFO audits. We discussed the benefits of the arrangement with NAS and other Navy personnel. To determine whether policy or resource constraints were impairing auditor independence, we reviewed FY 1995 through FY 1999 budget and manpower data. Regarding policy constraints, we reviewed the APG charter to determine whether procedures to maintain auditor independence were established. Concerning resource constraints, we reviewed budget and manpower data and discussed with NAS personnel whether the lack of NAS resources might prevent the NAS from performing critical or necessary work and thus impair independence.

**DoD Functional Area Reform Goals.** Most major DoD functional areas have also established performance improvement reform objectives and goals. This report pertains to achievement of the following functional area objective and goal.

**Financial Management Functional Area. Objective:** To implement the Government Performance and Results Act. **Goal:** Establish the framework for integrating the Government Performance and Results Act into the DoD Planning, Programming, and Budget System. (FM-6.2)

**General Accounting Office High-Risk Area.** The General Accounting Office has identified several high-risk areas in the DoD. This report provides coverage of the Defense Financial Management high-risk area.

**Use of Computer-Processed Data.** We did not use computer-processed data to perform this evaluation.

**Evaluation Type, Dates, and Standards.** We performed this program evaluation from July 1999 through September 1999 in accordance with standards issued and implemented by the Inspector General, DoD. The scope of the evaluation was limited in that we did not include tests of the management controls.

**Contacts During the Evaluation.** We visited or contacted individuals and organizations within DoD. Further details are available upon request.

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## **Appendix B. Prior Coverage**

During the last 5 years, the Inspector General, DoD, issued two reports addressing the process the Military Department audit agencies use for determining audit requirements and for requesting resources. Also, the Inspector General, DoD, issued one report concerning the Military Department audit agencies assignment of auditors to acquisition program offices and one report addressing the Military Department audit agencies extent and type of nonaudit work performed. In addition, the Army Audit Agency had conducted an external quality control review of the NAS.

### **Inspector General, DoD**

Inspector General, DoD, Report No. PO 99-6-007, "Air Force Audit Agency Process for Determining Audit Requirements and Requesting Resources," August 20, 1999.

Inspector General, DoD, Report No. PO 99-6-005, "Army Audit Agency Process for Determining Audit Requirements and Requesting Resources," May 27, 1999.

Inspector General, DoD, Report No. PO 97-039, "Evaluation of the Acquisition Audit Process," July 30, 1997.

Inspector General, DoD, Report No. PO 97-015, "Evaluation of Program Evaluation and Advisory-Type Services by the DoD Internal Audit Organizations," April 18, 1997.

### **Army**

Army Audit Agency Report No. AA 99-323, "Results of External Quality Control Peer Review," August 9, 1999.

## Appendix C. Other Matters of Interest

### Requesting Audit Resources

Except for the reimbursable arrangement, the NAS requests and receives its audit resources in a manner similar to the process other DoD agencies used to request and receive resources. The number of authorized personnel within NAS drives the request for audit resources. As a result, the NAS exhibited no unusual resource or request problems. Table B-1 shows the number of NAS full-time equivalents from FY 1995 through FY 2001.

**Table C-1. NAS Full-time Equivalents**

<u>FY 1995</u>	<u>FY 1996</u>	<u>FY 1997</u>	<u>FY 1998</u>	<u>FY 1999</u>	<u>FY 2000</u>	<u>FY 2001</u>
586	538	506	485	470	469	464

Table B-2 shows the NAS expenditures and projected budgets from FY 1995 through FY 2001.

**Table C-2. NAS Expenditures and Projected Budgets**  
(millions)

<u>Category</u>	<u>FY 1995</u>	<u>FY 1996</u>	<u>FY 1997</u>	<u>FY 1998</u>	<u>FY 1999</u>	<u>FY 2000</u>	<u>FY 2001</u>
Civilian Pay	\$36.416	\$36.507	\$34.900	\$35.423	\$35 436	\$36 848	\$37 920
Audit Travel	1 208	1 315	1 175	1 613	1 492	1.552	1.614
Training	0 633	0.505	0.626	0 202	0 405	0 469	0 483
Other	<u>3.122</u>	<u>2.875</u>	<u>2.851</u>	<u>2.598</u>	<u>4.603</u>	<u>2.144</u>	<u>1.418</u>
<b>Total</b>	<b>\$41.379</b>	<b>\$41.202</b>	<b>\$39.552</b>	<b>\$39.836</b>	<b>\$41.936*</b>	<b>41.013*</b>	<b>\$41.435*</b>

\* Includes Reimbursement Funding

### Auditor Independence

Nothing came to our attention to indicate that NAS independence was impaired due to policy or resource constraints. NAS had specific policies governing different types of review and NAS had sufficient resources to conduct mandatory and high priority audits.

**Capacity Evaluations.** NAS had a specific policy governing consulting type reviews. In May 1996, the NAS issued a memorandum addressing capacity evaluation policies and procedures (the NAS refers to consulting as capacity evaluations). The memorandum stated that the primary distinction between a

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capacity evaluation and an audit is the depth of review, or level of detail. A capacity evaluation may involve a scope that is far more limited than an audit to allow a faster response to the requesting official. According to the memorandum, during the field work phase of a capacity evaluation, the generally accepted government auditing standards of qualifications, independence, due professional care, supervision, and evidence must be followed.

**Effect of Resources on Auditor Independence.** We found no evidence suggesting that resource constraints had a negative impact on NAS independence. NAS was able to perform mandatory audits required by statute (for example, Chief Financial Officers Act). Similar to most DoD Components, NAS faced resource constraints at the same time as workload growth; however, NAS had sufficient resources to perform mandatory and high priority audits.



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## **Appendix D. Report Distribution**

### **Department of the Navy**

Naval Inspector General  
Auditor General, Department of the Navy

# Department of the Navy Comments



THE UNDER SECRETARY OF THE NAVY  
WASHINGTON DC 20350 1000

29 March 2000

MEMORANDUM FOR THE INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

Subj: DRAFT REPORT ON THE NAVAL AUDIT SERVICE PROCESS FOR  
DETERMINING AUDIT REQUIREMENTS AND REQUESTING RESOURCES

This memorandum provides the Department of the Navy (DON) response to the subject report

DON concurs with the recommendation to designate the Under Secretary of the Navy as the final review authority for the audit plan. The Audit Planning Group Charter will be revised by 31 May 2000 to be consistent with the requirement identified in Secretary of the Navy Instruction 7510 7E.

DON agrees with the intent of the second recommendation that is to designate the Under Secretary of the Navy as the adjudication authority for unresolved issues between the Auditor General of the Navy (AUDGENNAV) and Audit Planning Group (APG) members regarding planned audit coverage. This would be accomplished during the review of the audit plan by the Under Secretary. Therefore, no action is necessary to revise the Charter.

DON concurs with the intent of the recommendation to terminate the current reimbursement arrangement for financial statements audits by FY 2001. However, mission funding of all financial statement audit work performed by the Naval Audit Service cannot be accomplished by 1 October 2000. While realignment of Operation & Maintenance, Navy dollars will be changed during this summer's DON review of the FY 2002 budget estimates to reflect "fact of life" changes, other appropriations cannot be realigned without prior Congressional approval. Therefore, it is not anticipated that mission funding of all financial statement audit work performed by the Naval Audit Service would be accomplished until 1 October 2001.

There are several editorial changes to the report that should be made.

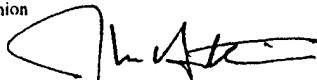
On page 8 of the draft report (Resource Issues paragraph) it is stated "However, the Navy policy that made NAS Chief Financial Officers (CFO) Act financial statement audits a reimbursable service was inefficient and created concerns about the stability of future Navy funding of the statutorily required CFO audits." There has never been a question that funding would not be provided. The DON is committed to ensuring that financial audits are fully funded. Therefore, it is suggested the wording "and created concerns about the stability of future Navy funding of the statutorily required CFO audits" be deleted.

Final Report  
Reference

Subj: DRAFT REPORT ON THE NAVAL AUDIT SERVICE PROCESS FOR  
DETERMINING AUDIT REQUIREMENTS AND REQUESTING RESOURCES

On page 11 of the draft report (Reimbursement Benefits Section) the last sentence of the first paragraph states "Given the chronic problems experienced by the Navy in the finance and accounting area, it should avoid unnecessarily complex funding and accounting arrangements." Reimbursable funding is not a complex issue if properly implemented. Therefore, it is suggested this sentence be deleted. Also, the third paragraph deals with the results of the reimbursement process. Since this conclusion appears to be based on opinion, this paragraph should be rewritten to clarify that it is your opinion.

Revised



Jerry MacArthur Hultin

## **Evaluation Team Members**

The Deputy Assistant Inspector General for Audit Policy and Oversight, Office of the Assistant Inspector General for Auditing, DoD, prepared this report.

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